
LAC Success Put to the Test

2011 Spring Meetings

Washington, DC
13 April 2011

***Chief Economist Office
Latin America and the Caribbean
The World Bank***



LAC Success Put to the Test

1. Characterizing the Recovery
2. Risks stemming from the External Front and from Home-Grown Dynamics
3. Policy Tradeoffs and Tensions Ahead

LAC Success Put to the Test

1. Characterizing the Recovery

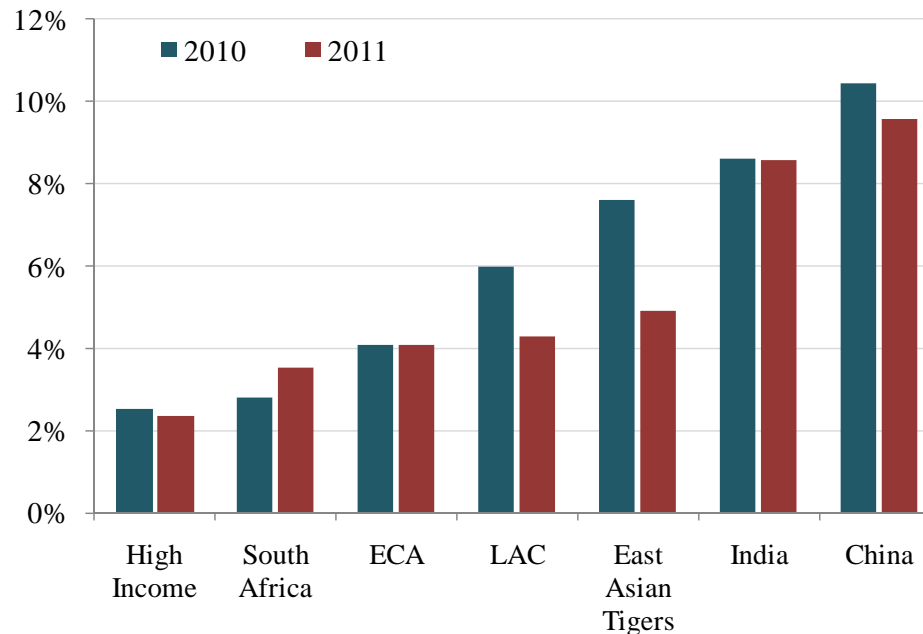
2. Risks stemming from the External Front and from Home-Grown Dynamics

3. Policy Tradeoffs and Tensions Ahead

Emerging economies as engines of global growth, with some LAC countries in the pack

- LAC 's growth recovery still exceeds expectations
 - In 2010 lower than East Asian Tigers but higher than ECA; in 2011 comparable to East Asian Tigers

Real GDP Growth and Forecasts around the World
Annual Real GDP Growth Rate, Weighted Averages

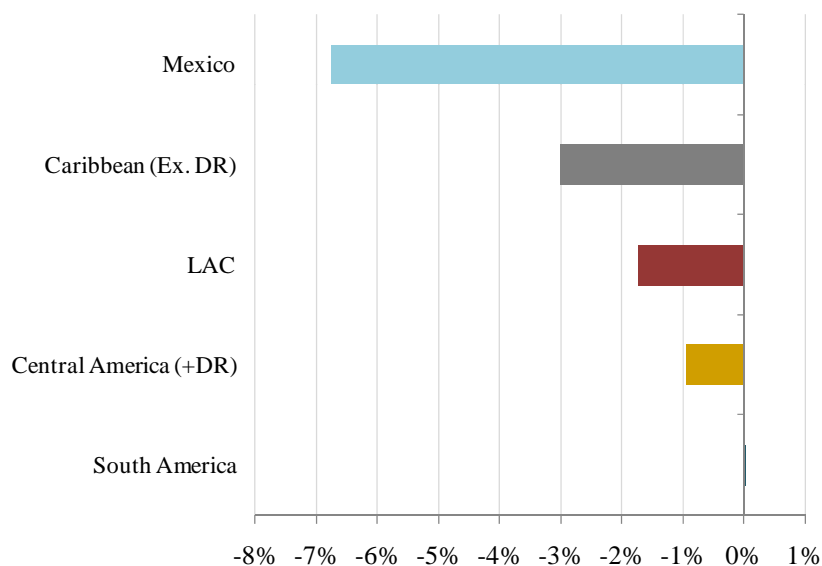


Notes: For all countries we used the latest available projection. Sources: Consensus Forecasts (March 2011), The World Bank's Global Economic Prospects - GEP (January 2011), and IMF's World Economic Outlook (October 2010).

English-speaking Caribbean nations and Mexico have had weaker performance through the cycle

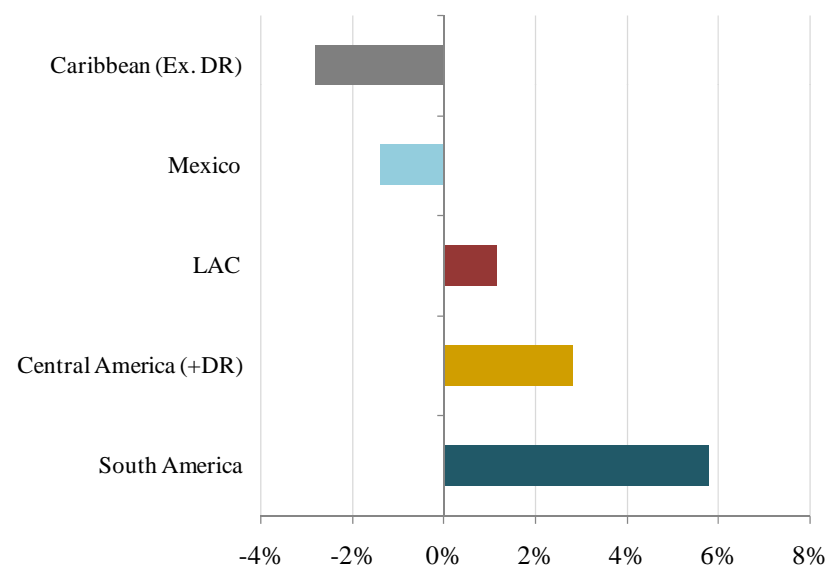
Level of GDP in 2009 Compared to Level of GDP in the Peak

Logs of the Ratios, Simple Averages



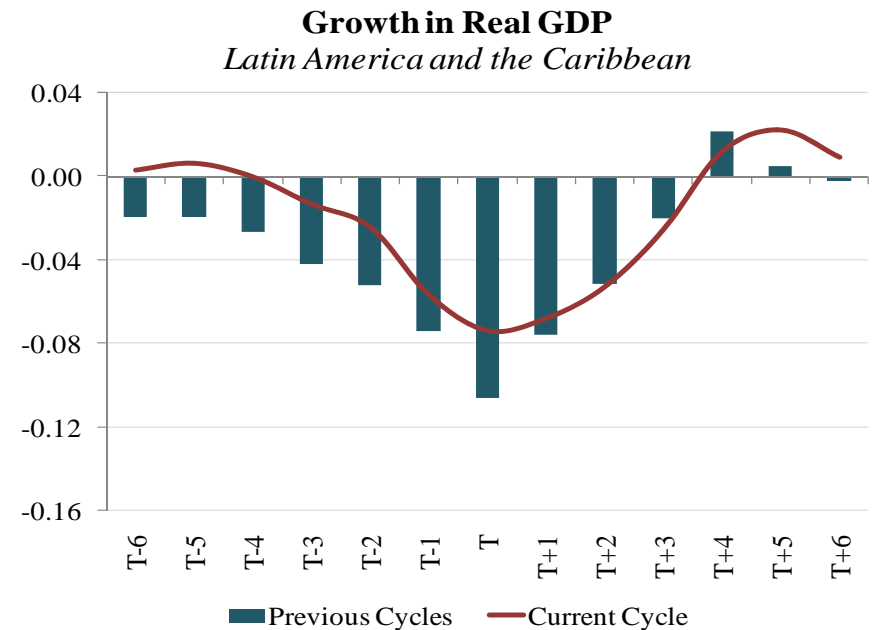
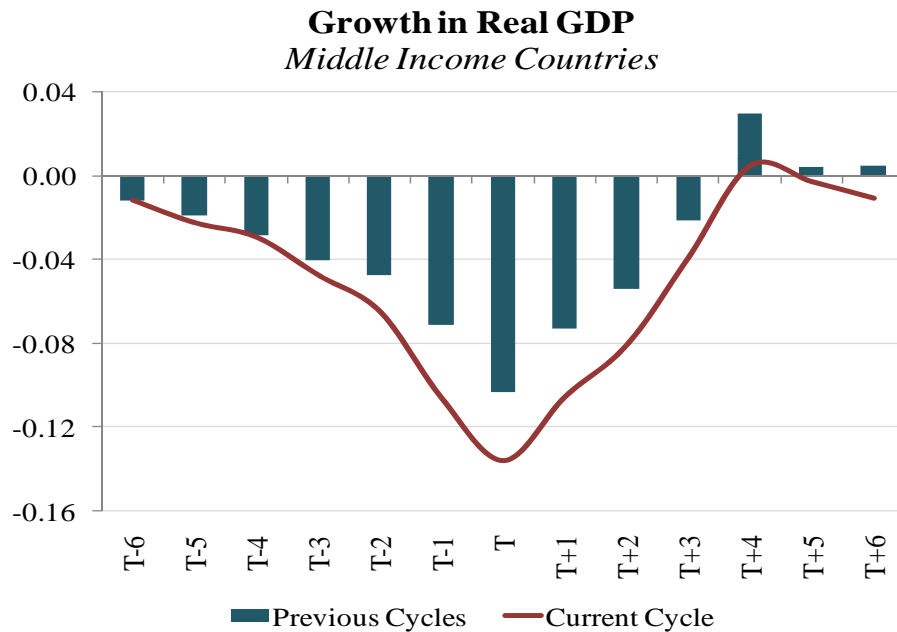
Level of GDP in 2010 Compared to Level of GDP in the Peak

Logs of the Ratios, Simple Averages



Notes: The figures compare the 2010 real GDP levels with their pre-crisis peak, which is the maximum annual value of real GDP in the period 2007-2008. Real GDP in 2010 is constructed based on forecast growth rates for 2010 – the latest available for each country. Sources: World Bank's WDI (December 2010), IMF's WEO (October 2010), The World Bank's Global Economic Prospects – GEP (January 2011), and Consensus Forecasts (March 2011).

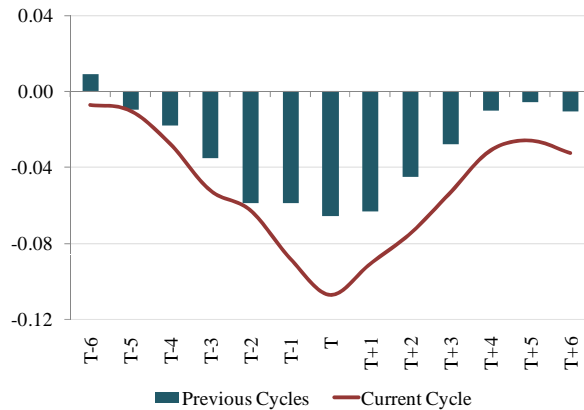
LAC outperformed its own past and the MIC average this time around



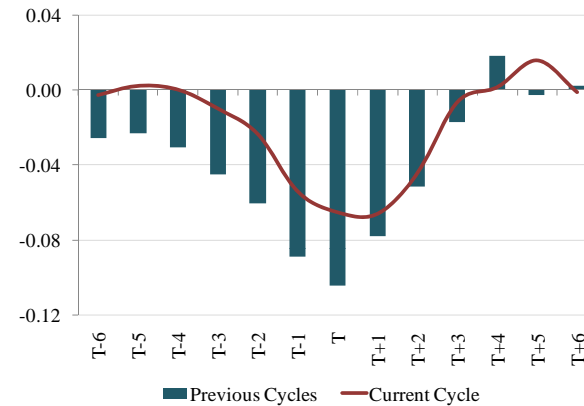
Notes: The figures represent the deviations from regional/group trend growth in real GDP on 13-quarter windows centered on previous and current troughs on real GDP. This figure depicts the behavior of real GDP in previous and current recession-recovery cycles. Sources: IMF's International Financial Statistics – IFS, National Statistical Institutes and Central Banks, Haver Analytics.

Recovery is driven mostly by a buoyant domestic demand-- public and private consumption...

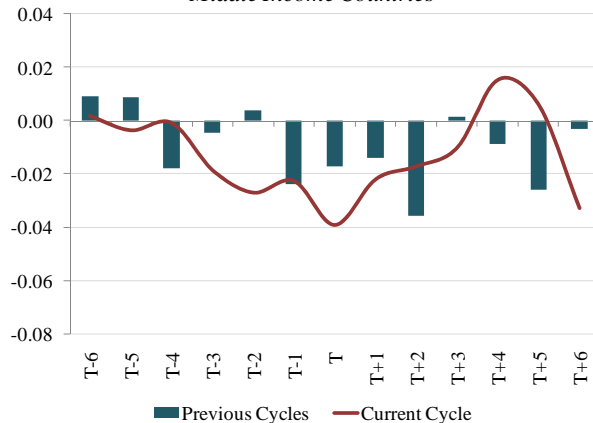
Growth Rates in Private Consumption
Middle Income Countries



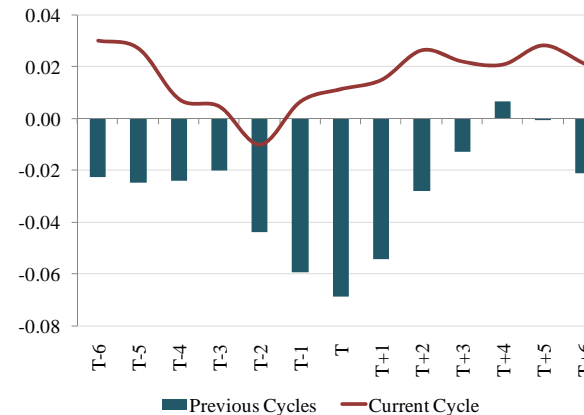
Growth Rates in Private Consumption
Latin America and the Caribbean



Growth Rates in Public Consumption
Middle Income Countries



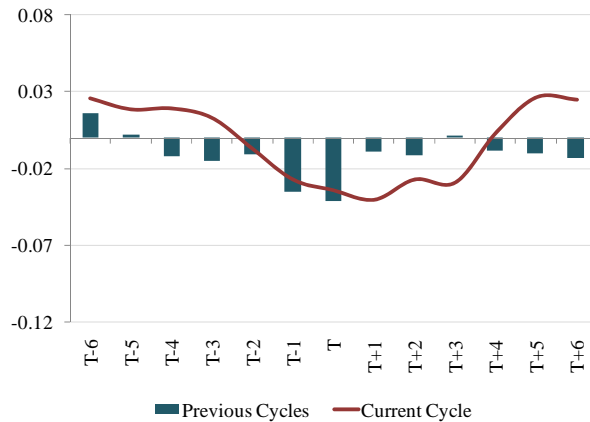
Growth Rates in Public Consumption
Latin America and the Caribbean



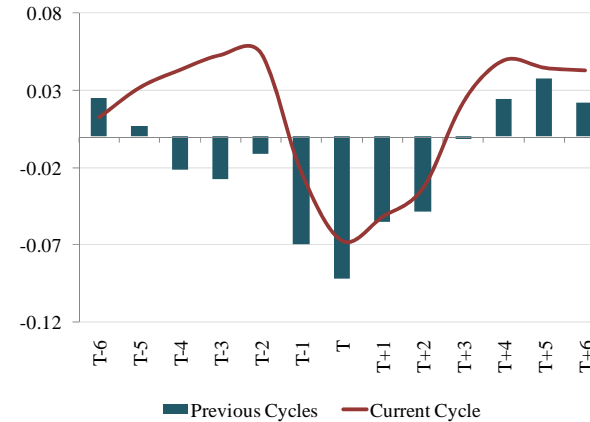
Notes: The figures depicted here represent the deviations from regional/group trend growth in private and public consumption on 13-quarter windows centered on previous and current troughs on real GDP. Sources: IMF's IFS, National Statistical Institutes and Central Banks, Haver Analytics.

... and it has come along with stronger currencies and favorable terms of trade

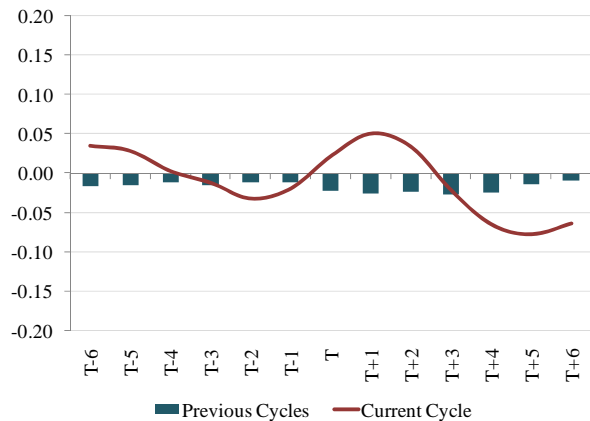
Growth in Real Effective Exchange Rate
Middle Income Countries



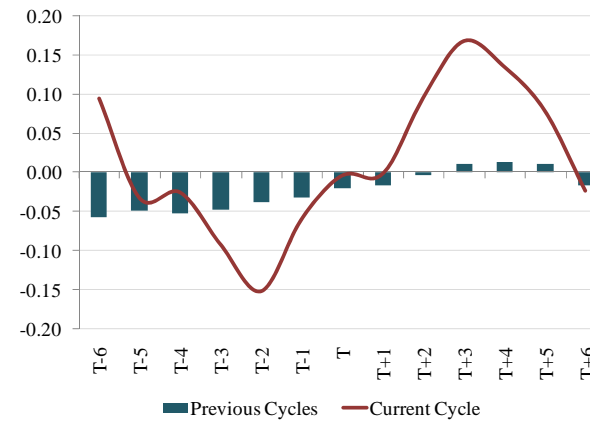
Growth in Real Effective Exchange Rate
Latin America and the Caribbean



Growth in Terms of Trade
Middle Income Countries



Growth in Terms of Trade
Latin America and the Caribbean



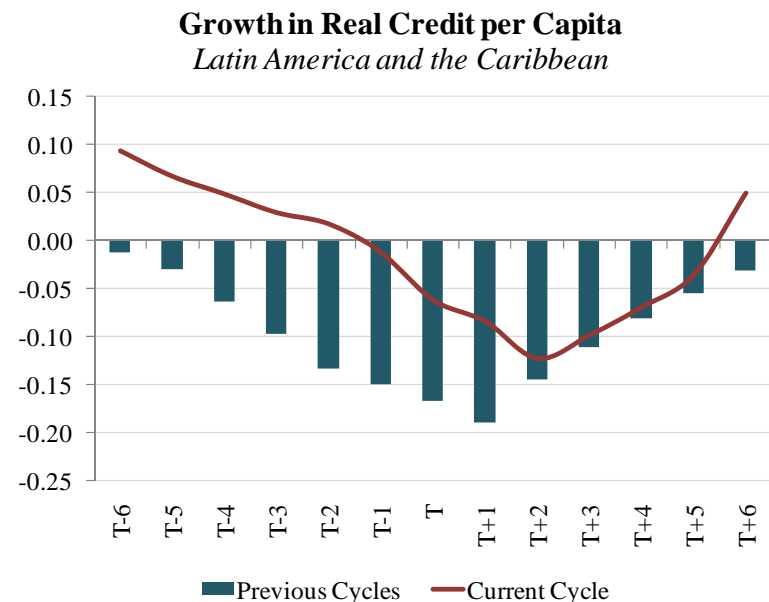
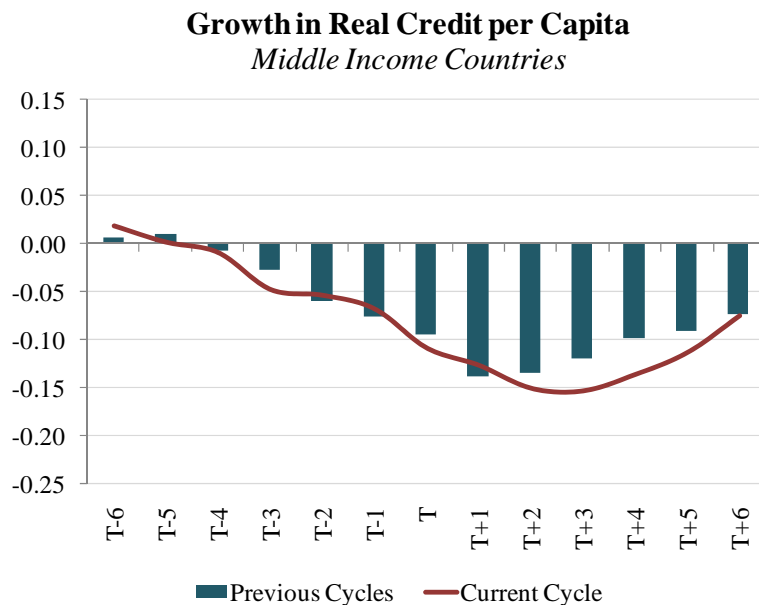
Notes: The figures depicted here represent the deviations from regional/group trend growth in real effective exchange rate and terms of trade on 13-quarter windows centered on previous and current troughs on real GDP. Sources: IMF's International Financial Statistics – IFS, National Statistical Institutes and Central Banks, Haver Analytics.

Stronger appreciations in LAC than in other MICs

- Reflection of a powerful combination of
 - Surging capital inflows
 - Rising terms of trade
 - High real interest rates in the region
 - Due in part to credibility gaps in the LAC region left over from a past history of volatility and financial instability
 - Due in part to closing output gaps – structural speed limits to non-inflationary growth tend to bind earlier
 - Optimism regarding growth prospects
 - Exchange rates are on average more heavily managed in other MICs than in LAC

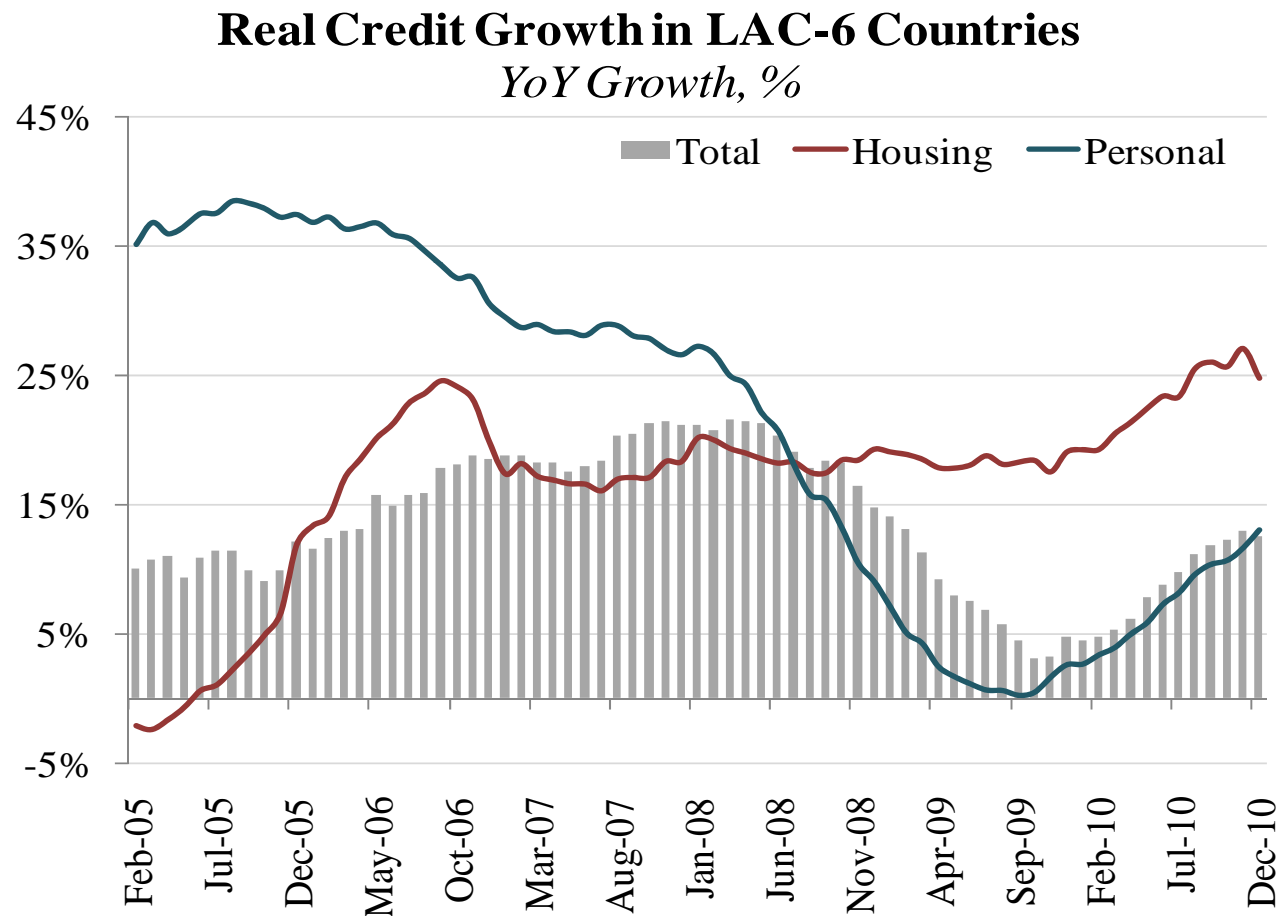
This has not been a credit-less recovery...

- Reflects factors associated with the new-found resiliency in the LAC region
 - Balance sheets of the banking system were not impaired
 - Demand for credit was quickly restored
 - Capital inflows resumed rapidly and strongly



Notes: The figures depicted here represent the deviations from regional/group trend growth in real credit (per capita) on 13-quarter windows centered on previous and current troughs on real GDP. Sources: IMF's International Financial Statistics – IFS, National Statistical Institutes and Central Banks, Haver Analytics.

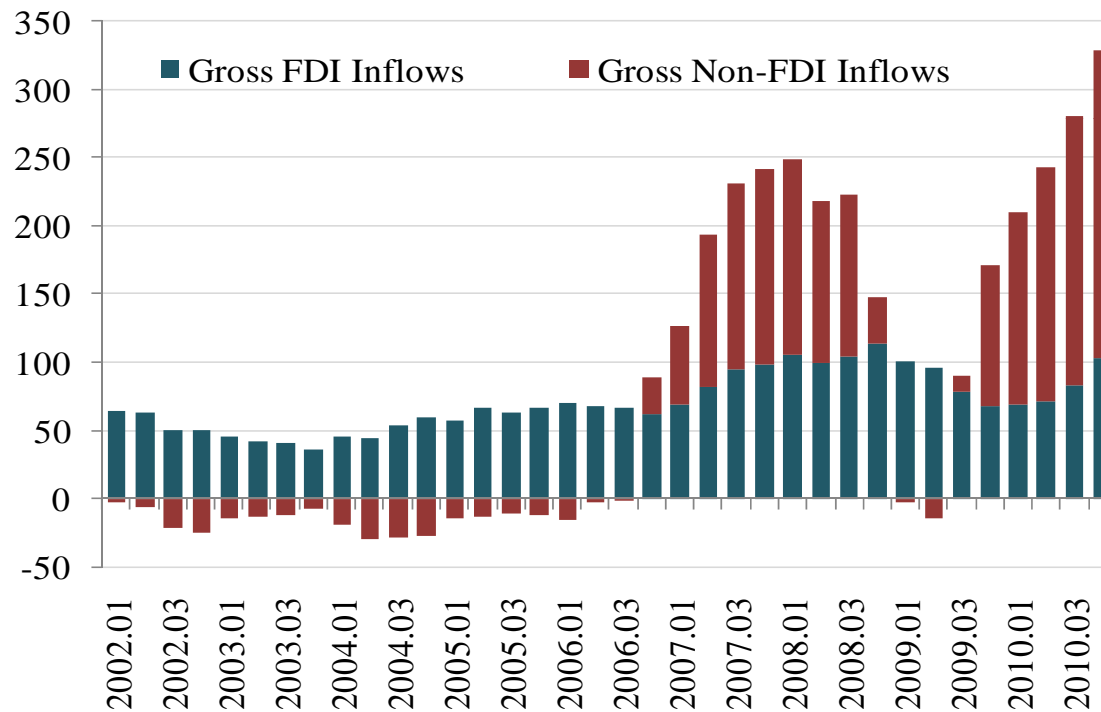
... and mortgage credit showed striking resilience



Notes: The figure depicts the (PPP-GDP) weighted average of the growth rates of (total, personal and housing) credit to the private sector for the six largest LAC countries (Argentina, Brazil, Chile, Colombia, Mexico, and Peru). Sources: National Statistical Institutes, Central Banks, and Superintendence of Banking.

Quick recovery in domestic credit reflects in part strong capital inflows

Gross Inflows to LAC-7 Countries
In US\$ Billions

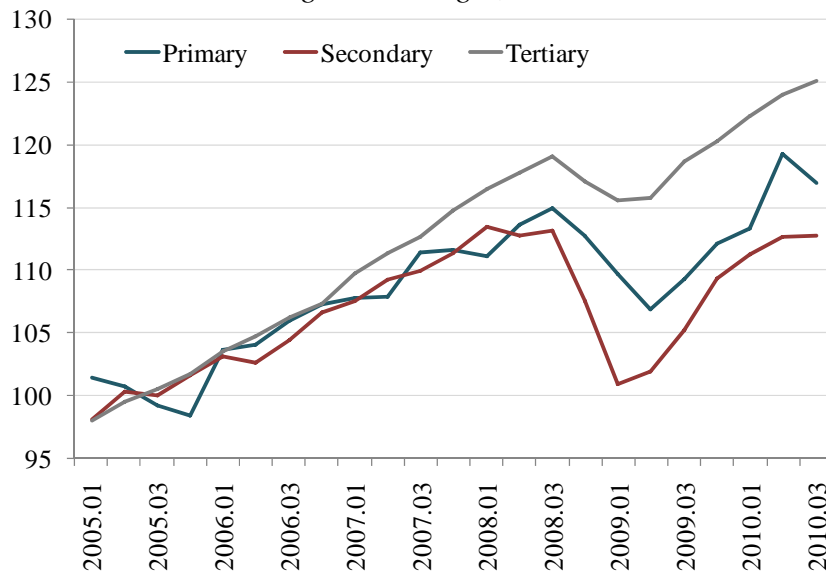


Notes: Annualized capital inflows to LAC-7. Sources: IMF's Balance of Payments Statistics, National Statistical Institutes, and Central Banks.

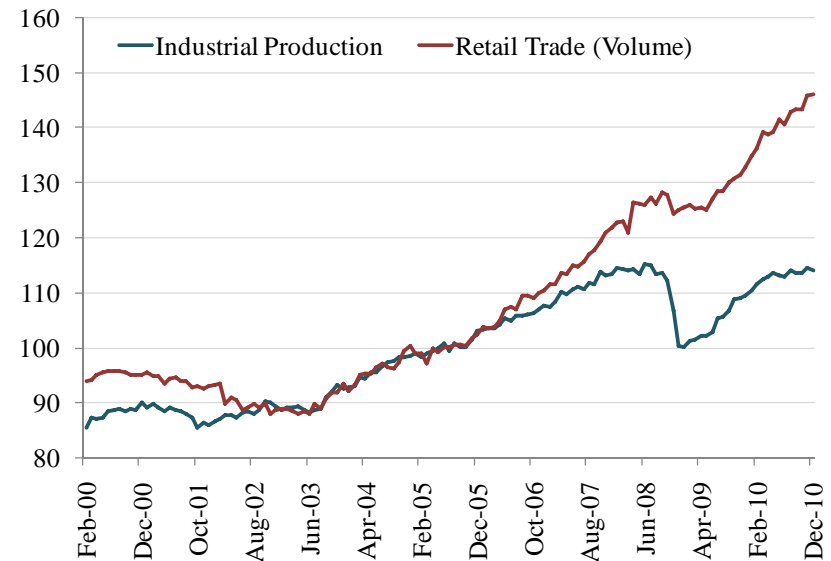
Strong expansion of the non-traded sector relative to the traded sector ...

- Not independent of the strengthening of the currency

LAC-7: Real GDP by Type of Economic Activity
PPP-GDP Weighted Averages, Index 2005 = 100



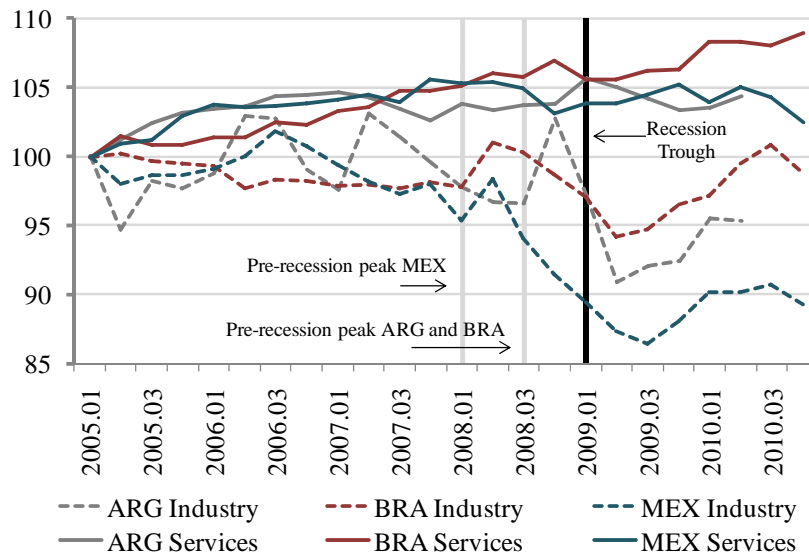
Industrial Production and Retail Sales in LAC-6
Real Prices, Weighted Averages, Index 2005=100



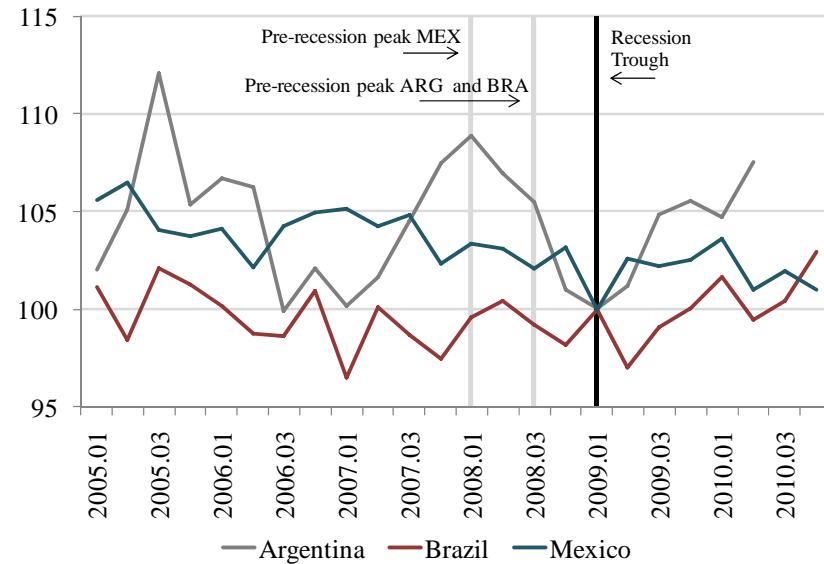
Notes: The two figures present PPP-GDP weighted averages. For the figure on the right, the six countries considered were: Argentina, Brazil, Chile, Colombia, Mexico, and Peru. Nominal retail sales are deflated by the CPI. Sources: National Statistical Institutes and Central Banks, Haver Analytics, and Bloomberg.

... is also reflected in the labor market

Employment as % of the Working Population
Manufacturing and Services



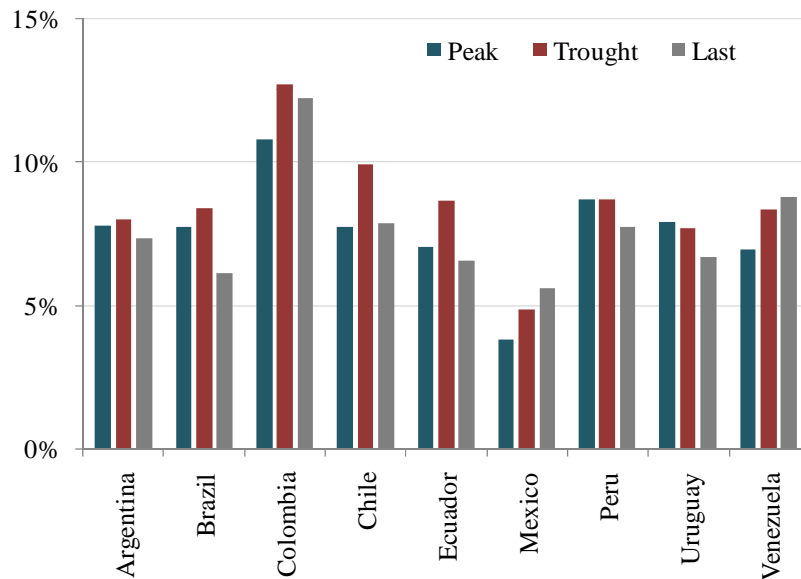
Relative Wages
Ratio between Wages in Retail Trade and Manufacturing



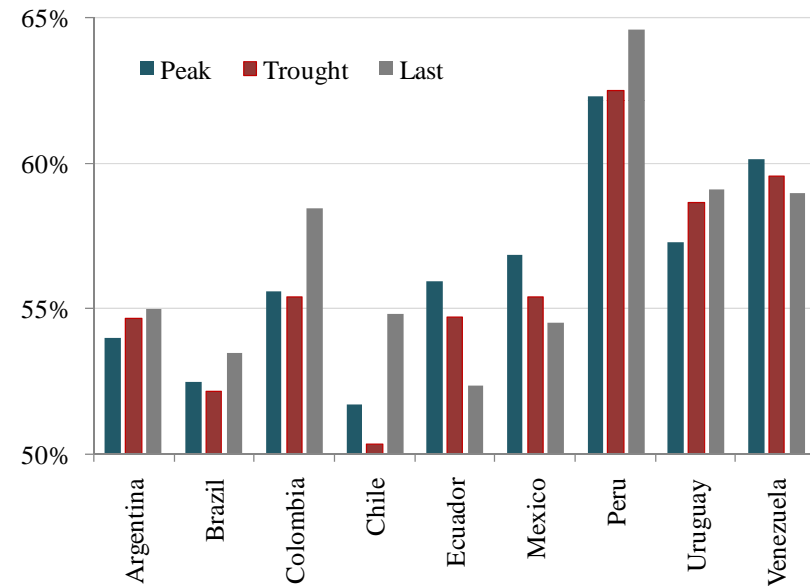
Notes: All series are indexed to 100 at 2005q1 (2009q1) in Panel A (Panel B). Seasonally adjusted using X12-ARIMA. Sources: LCRCE staff calculations using: Argentina: Encuesta Permanente de Hogares (EPH), Brazil: Pesquisa Mensal de Emprego (PME), and Mexico: Encuesta Encuesta Nacional de Ocupación y Empleo (ENOE).

Recovery in LAC was not jobless: declining unemployment and rising employment rates

Unemployment Rate in LAC Countries



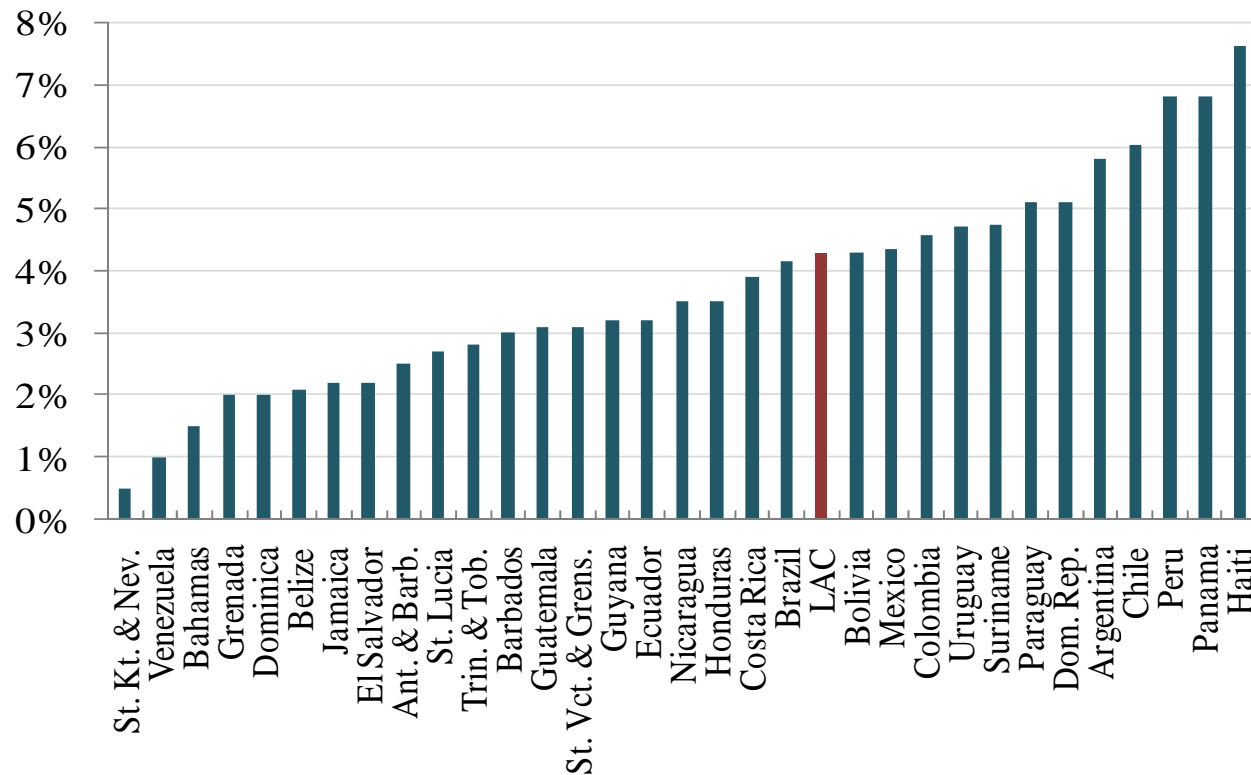
Employment Rate in LAC Countries



Notes: Peaks and troughs in real GDP were identified using Harding and Pagan's BBQ algorithm. The peak in real GDP for Argentina, Brazil, Ecuador, Peru, and Uruguay was 2008q3; Chile was 2008q2, Colombia 2007q4, Mexico 2008q1, and Venezuela, 2008q4. The trough in real GDP was 2009q1 for Argentina, Brazil, Colombia, Mexico, and Uruguay, 2009q3 for Chile, Ecuador, and Peru, and 2009q1 for Venezuela. The last quarter available of information for real GDP across LAC countries was 2010q4 —except for Argentina (2010q3). Real GDP was seasonally adjusted. Sources: Organización Internacional del Trabajo – OIT (2010).

Growth in 2011 will continue at different paces and intensities across LAC countries

Real GDP Growth Forecasts for 2011
LAC Countries



Notes: For all countries we used the latest available projection. Sources: Consensus Forecasts (March 2011), The World Bank's Global Economic Prospects - GEP (January 2011), and IMF's World Economic Outlook (October 2010).

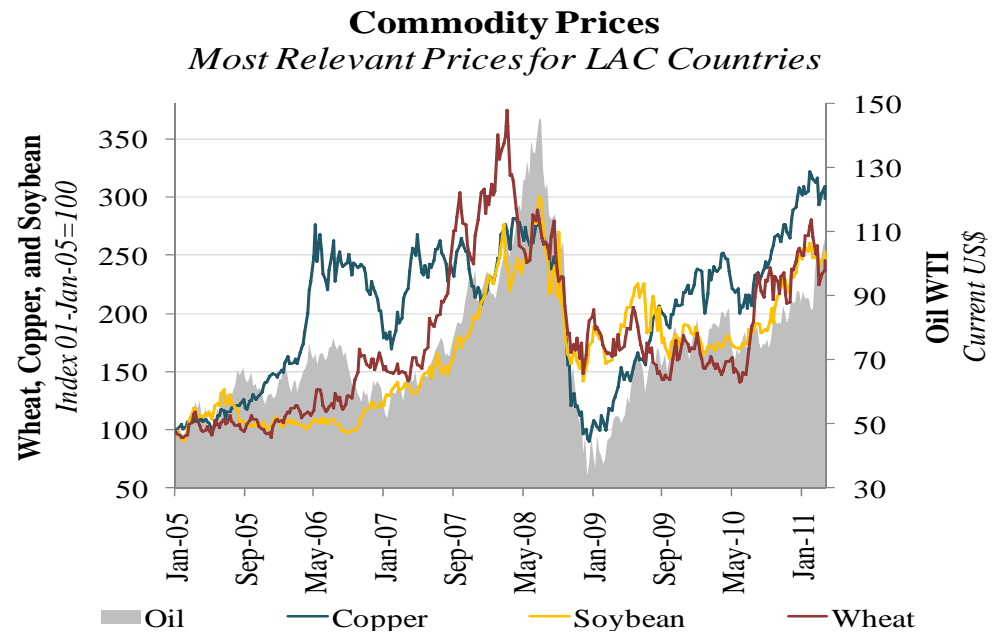
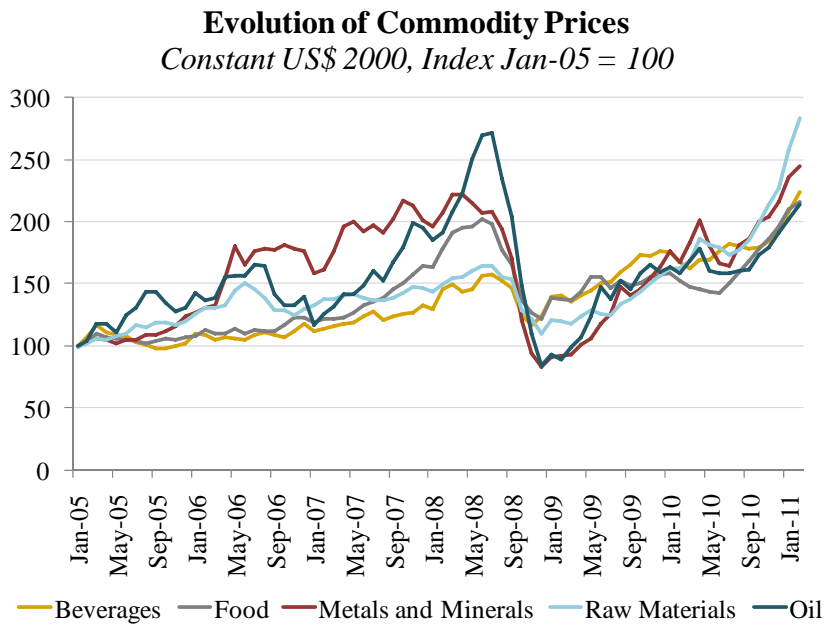
LAC Success Put to the Test

1. Characterizing the Recovery
2. Risks stemming from the External Front and from Home-Grown Dynamics
3. Policy Tradeoffs and Tensions Ahead

Exogenous factors: *strong growth in the US and Germany clouded by developments in Japan*

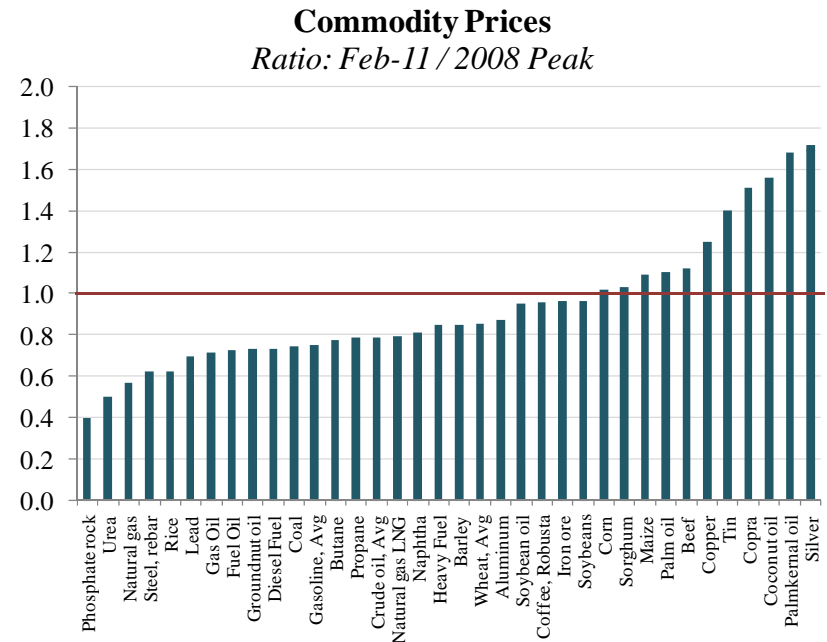
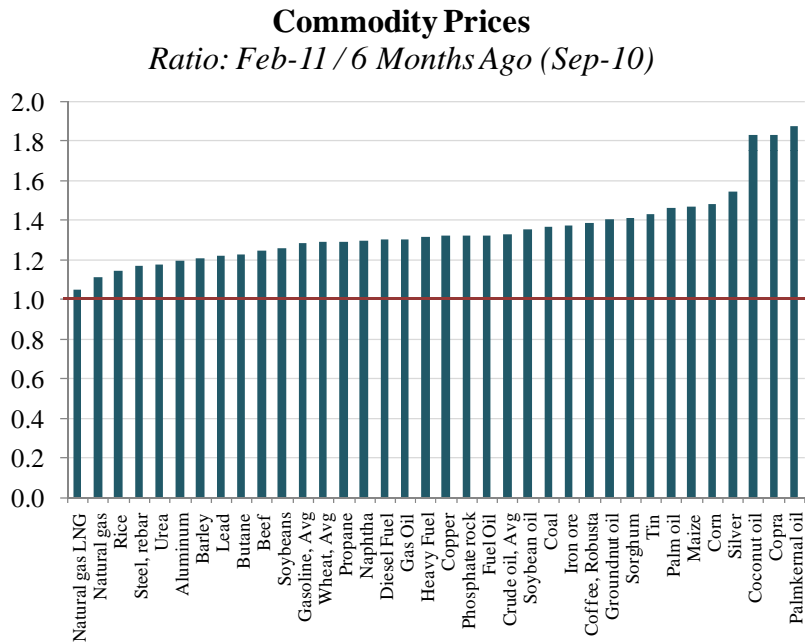
- Major central banks may advance the timetable for raising interest rates
 - Stronger recovery than previously expected, specially in the US and Germany
 - Possibility of higher core-inflation due to high fuel prices
- Japan complicates the scenario
 - Global supply chains: key supplier for selected industries
 - Massive reconstruction
- Fears about a full-blown debt/financial crisis in peripheral Europe have subsided
 - Although no clear final resolution has been yet put in place

Exogenous factors: *High and volatile commodity prices*



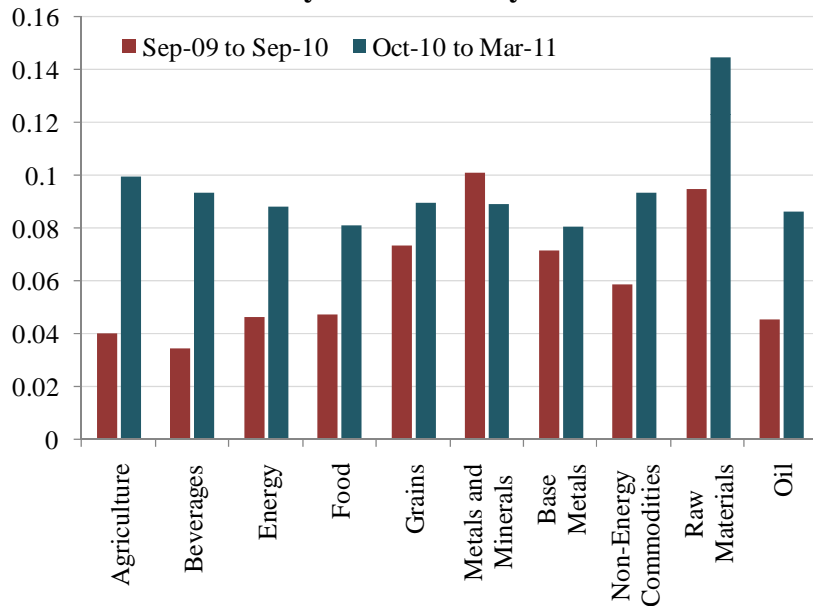
Notes: For Panel A, oil is the average of Brent, WTI and Dubai prices. Sources: World Bank's Global Economic Monitor – GEM (Panel A) and Bloomberg (Panel B).

The prices of many commodities have surpassed their pre-crisis peaks...

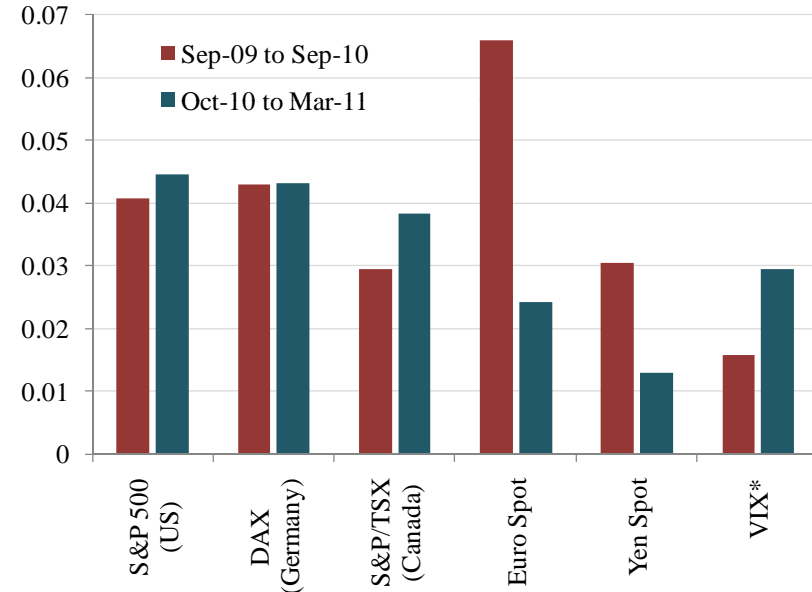


... with turmoil in MENA and the disaster in Japan leading to increased uncertainty

Volatility in Commodity Markets



Volatility in Financial Markets



Notes: *The VIX is presented as the average in the period divided by 1000. Also, only in the case of VIX, the red bar represents the minimum value for the period Sep-09 to Sep-10 and the blue bar represents the maximum value for the period Oct-10 to Mar-11. For all other variables, volatility was defined as the standard deviation of the period divided by the average in that same period. Sources: World Bank's GEM and Bloomberg.

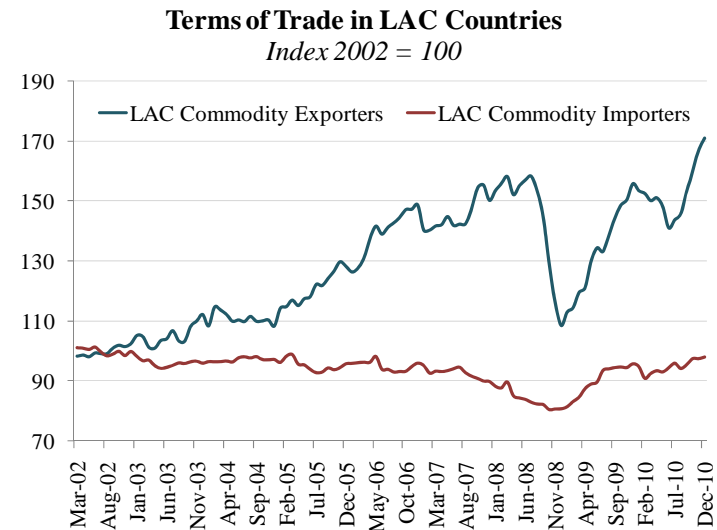
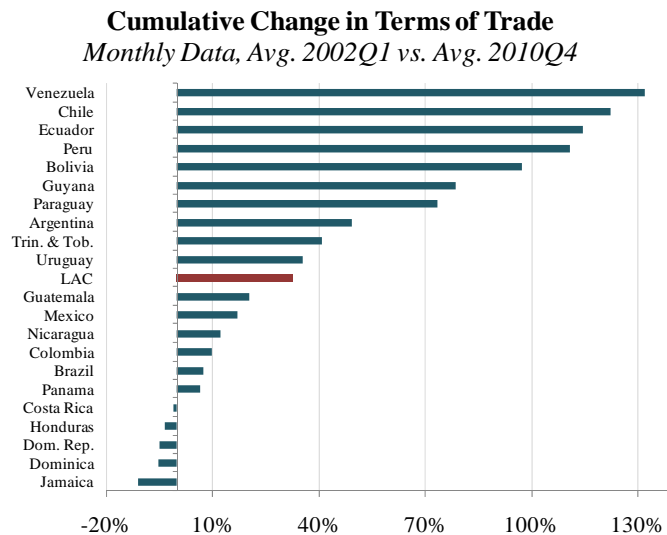
Food crisis: Déjà vu?

- Structural demand factors stemming from the fast-growing economies in emerging Asia
- Low interest rates in advanced countries and global investors shifting portfolios towards riskier assets
- Supply factors related to adverse climatic changes are affecting crop conditions [e.g. Argentina, Australia, China, and Colombia]
- Protectionist measures have emerged (e.g. Russia)
- As oil prices increase, the production of bio-fuels might also go up, further fueling upward pressures on food prices

Food and fuel prices - transmission channels

Terms of trade

- At the *aggregate level*, rising food and fuel prices have an asymmetric impact across the region
 - Gains for exporters of both agricultural and non-agricultural commodities
 - Losses for net importers of foodstuffs and non-agricultural commodities



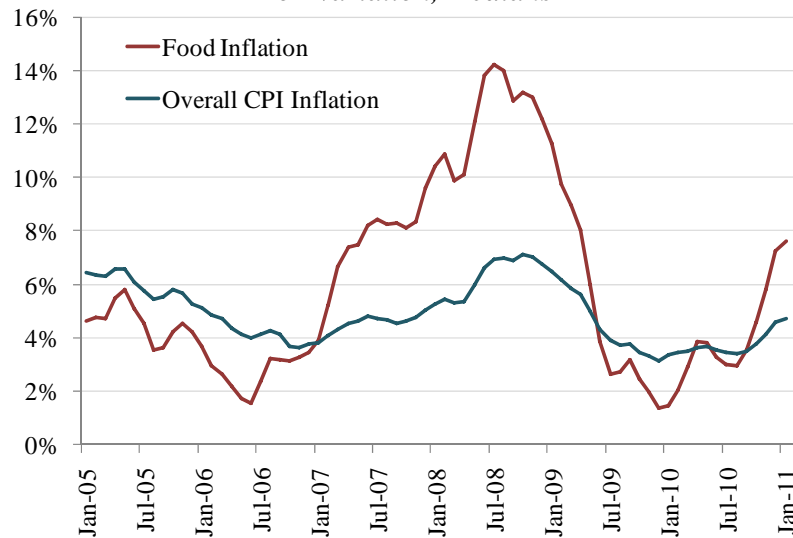
Notes: Monthly and seasonally adjusted data. Group averages reported in Panel B are simple averages. LAC's net commodity exporters are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela. The group of commodity importers in the region is composed by Costa Rica, Dom. Rep., El Salvador, Guatemala, Honduras, Haiti, Jamaica, Nicaragua, and Panama. Sources: World Bank's GEM.

Food and fuel prices - transmission channels

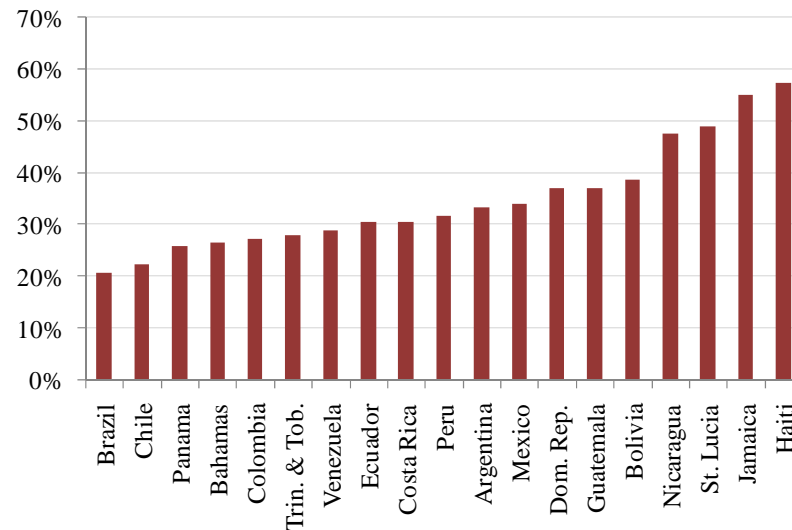
Pressures on the local CPI

- A concern for all countries in the region
 - Greater concern for countries with a higher share of food in consumption baskets

Food and Overall CPI Inflation : LAC-7 + URY
YoY Variation, Medians



Food Expenditure as % of Total Consumption
Within LAC Countries



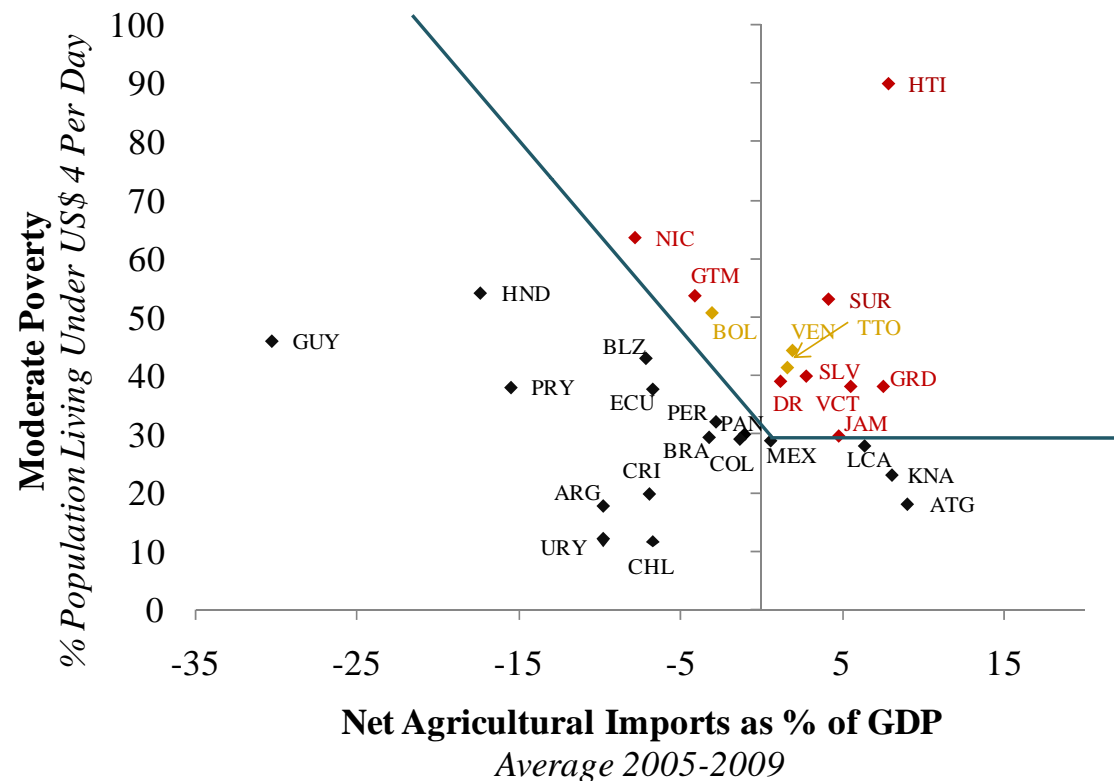
Notes: There is a change in the methodology of calculation for both food and overall PCI index for Chile since January 2009. For the figure on the right, we used the latest available figure for each country. Weighted averages (2007 Nominal GDP in USD Billions) were used in the case of the regional numbers. Sources: Bloomberg, Instituto Nacional de Estadísticas de Chile – INE, and Food and Agriculture Organization – FAO (2010) and IMF's World Economic Outlook – WEO (October 2010).

Food and fuel prices – transmission channels

Distributional effects

- Less vulnerable countries, *in principle*
 - Major commodity exporter
- But even for those with gains in TOT
 - Poverty levels
- Worse off
 - TOT losers
 - High poverty
 - Narrow fiscal space
 - Lack of safety nets

Poverty, Net Agricultural Imports, and Public Policy

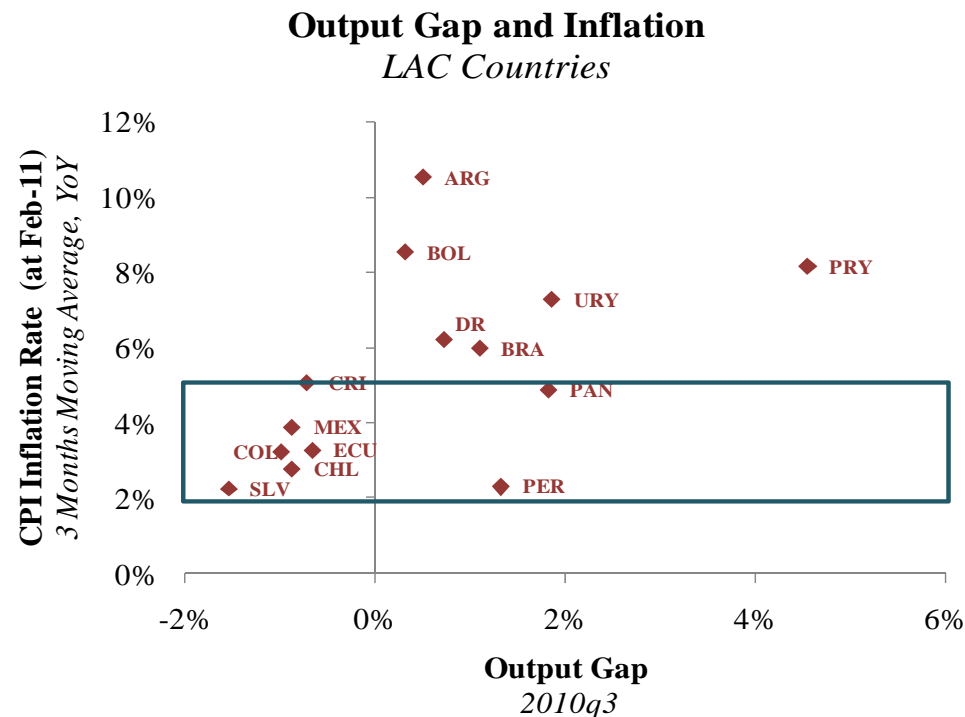


Notes: Countries in orange are those that are net exporters of non-agricultural commodities or have reasonable fiscal spaces. Countries in the region that are the most sensitive/vulnerable to rising food prices are those that have more than 30% of the population living under US\$ 4 per day and that are net importers of food. The line signals the fact that the poverty constraint is more binding than the net importer/exporter status. Sources: World Bank's WDI, IMF's WEO, World Bank's LCSP.

Risks from home-grown dynamics:

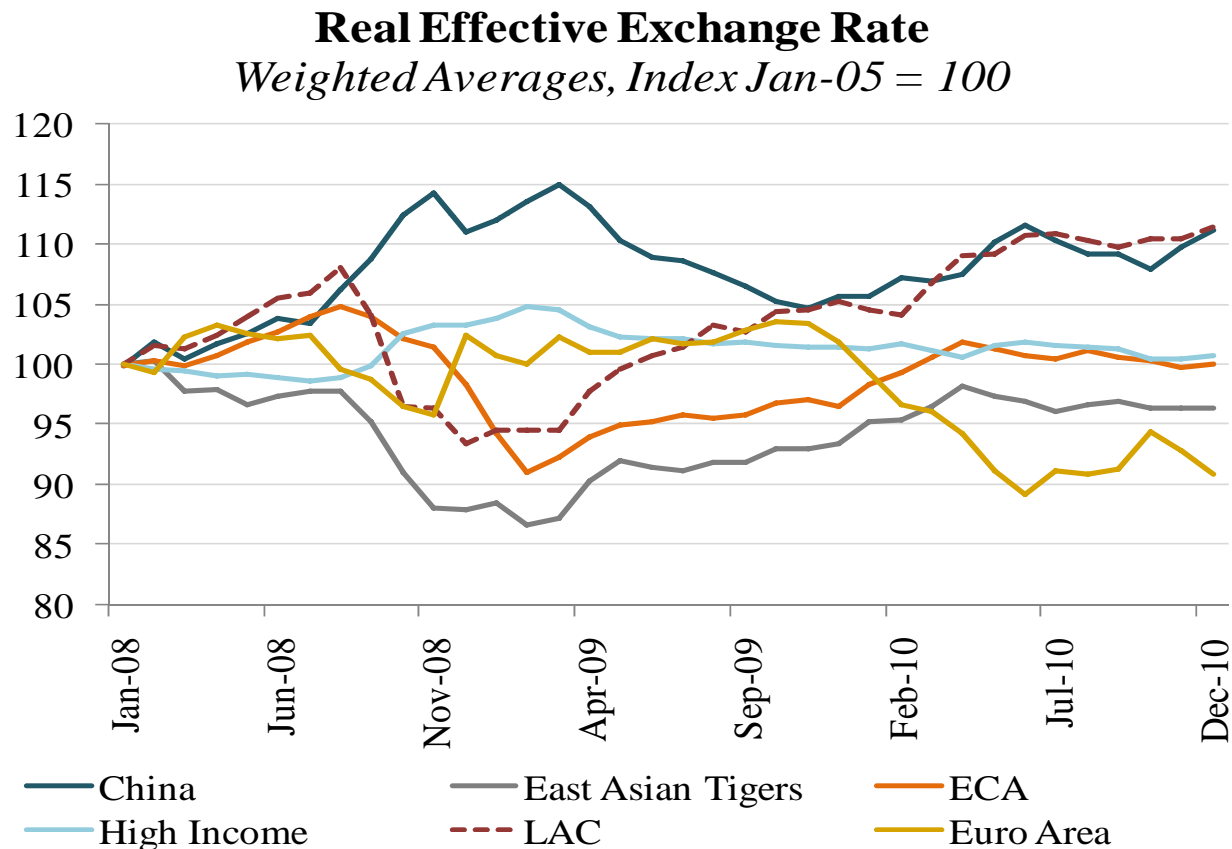
Closing output gaps and inflationary pressures

- Inflationary pressures stemming from
 - GDP growth beginning to hit *capacity constraints*
 - Rising fuel and food prices



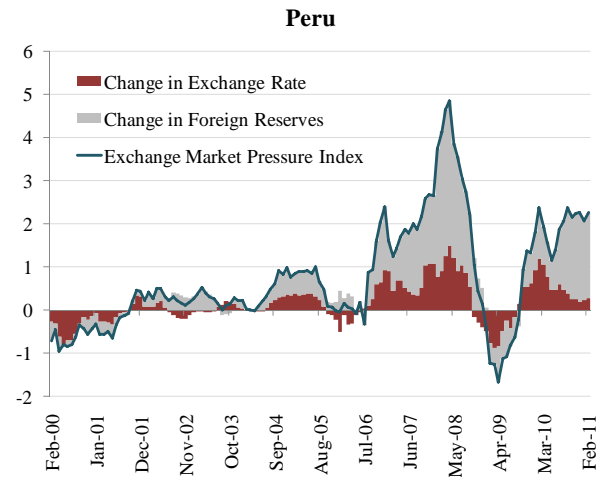
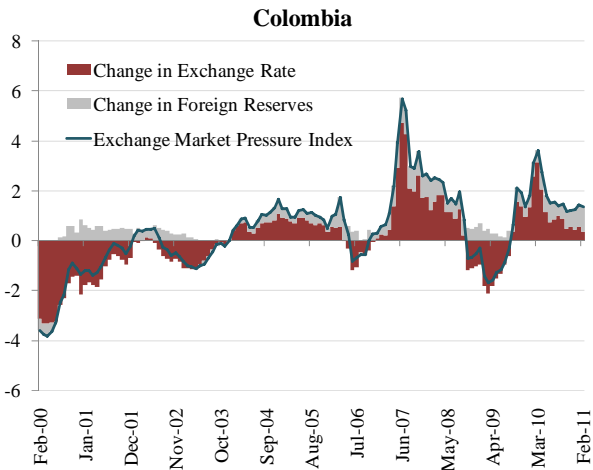
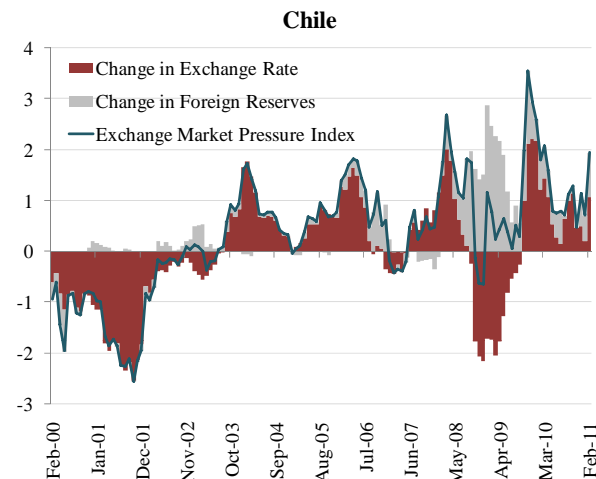
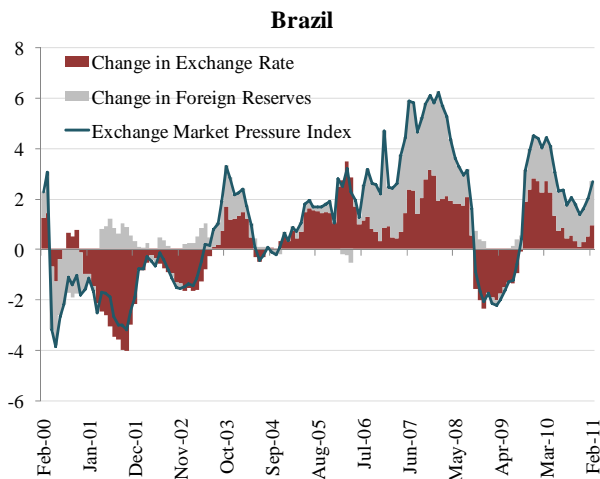
Notes: The area inside the box represents the range between the lowest and highest midpoints among inflation targeting countries. Sources: National Statistical Institutes and Central Banks, Haver Analytics.

Risks from home-grown dynamics: “Excessive” currency appreciation



Notes: Panel A shows the annualized capital inflows to LAC-7. In the case of Panel B, weighted averages were calculated using the 2007 nominal GDP in USD Billions. In that same Panel, an increase means an appreciation of the REER. Sources: IMF’s Balance of Payments Statistics, National Statistical Institutes, and Central Banks (Panel A), IMF’s International Financial Statistics – IFS and IMF’s World Economic Outlook – WEO (October 2010) (Panel B).

Appreciation pressures do not recede across many LAC countries...



Notes: The EMP index is the weighted average of YoY% changes in: (a) the nominal exchange rate of the local currency vis-à-vis the US dollar (such that an increase represents an appreciation of the LAC currency), and (b) the level of international reserves. The weights are given by the inverse of the annual standard deviation of the changes in the nominal exchange rate and the standard deviation of the changes in reserves. An increase in the EMP index signals appreciation pressures and/or accumulation of reserves. Sources: LCRCE Staff calculations based on IMF's International Financial Statistics – IFS.

LAC Success Put to the Test

1. Characterizing the Recovery
2. Risks stemming from the External Front and from Home-Grown Dynamics
- 3. Policy Tradeoffs and Tensions Ahead**

Macro-financial tensions at home...

Scope for policy tradeoffs has widened considerably

- During the downturn: no trade-offs
 - Counter-cyclical fiscal and monetary policies meant easing conditions, consistent with a needed depreciation of the currency.

- During the upturn: rising tensions and trade-offs
 - Need to pre-empt inflation in the face of closing output gaps and pressures from high food and fuel prices
 - → Higher interest rates / higher fiscal savings, protecting social programs
 - Concern about “excessive” currency appreciation in face of high and volatile commodity prices and capital flows
 - → Lower interest rates / higher fiscal savings, protecting social programs

... increase the premium on skillful macro-financial policy management

Authorities need to shift from a “crisis management” mode to a “mature cycle management” mode

- There is no policy silver bullet as “corner solutions” and pure orthodox solutions are **unfeasible** or **undesirable**:
 - Free floating currencies
 - Inflation
 - Major compression go of domestic demand
- Hence, a “hybrid” pragmatic approach stands to reason -- with a suitable mix of monetary, fiscal, and macro-prudential policies

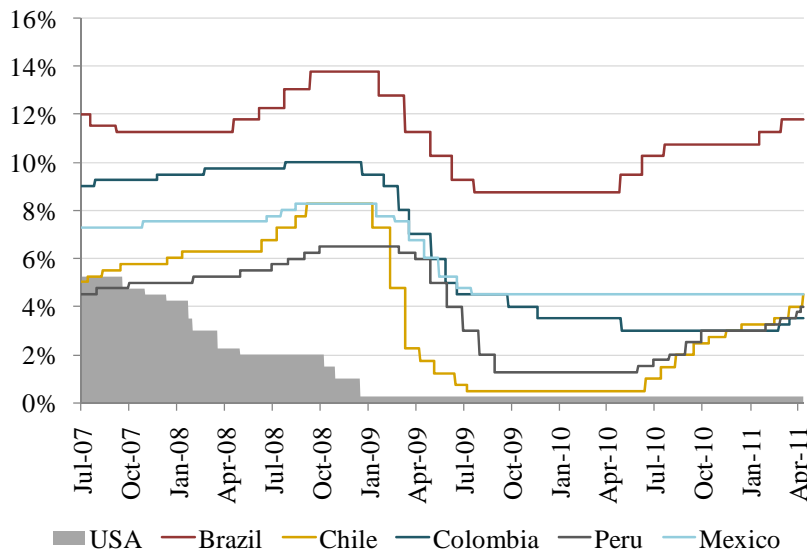
The hybrid approach

- It involves some combination of
 - Intervention in foreign exchange markets with the consequent and accumulation of int'l reserves and sterilization measures
 - Monetary policy tightening
 - Some measure of fiscal policy tightening
 - A willingness to allow inflation to *transitorily* stay close to or slightly above the upper band of the inflation target
 - Broadly-defined macro-prudential interventions, including controls on capital inflows

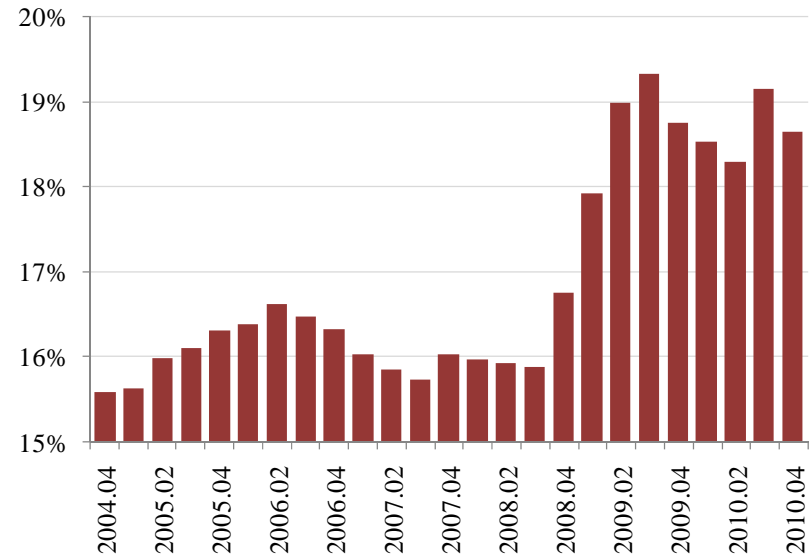
But hybrid approach has been unbalanced: over-relying on monetary policy...

- Fiscal policy is “behind the curve” – in fact it has become pro-cyclical

Monetary Policy Rates
Inflation-Targeting LAC Countries



Primary Expenditure
% of GDP, LAC-6 Countries



Notes: The figures in Panels B and C are the cyclically-adjusted primary expenditure and primary balance for the major six LAC countries (Argentina, Brazil, Chile, Colombia, Mexico, and Peru). Sources: Bloomberg, Haver Analytics, National Statistical Institutes, and Central Banks.

... and can be improved

- An increase in fiscal savings is highly desirable
 - Greater need in countries that are experiencing a major commodity related windfall and/or copious short-term capital inflows
- More systematic and judicious use of macro-prudential policies *as a complement*
 - Essential to forestall the undesirable systemic financial vulnerabilities that can arise (e.g. as a result of asset bubbles)
- Learn to live with a more appreciated level of the local currency and focus on productivity enhancements
 - To the extent that it is an unavoidable part of the adjustment process to improved growth prospects, rising terms of trade, and strong FDI

Skilful cycle management is necessary to turn a cyclical recovery into a higher trend growth

- Successful management of the cycle is essential to break free from the historical boom-bust pattern
- The bumps against *structural speed limits* at comparatively low growth rates
 - Key reason why sustained high growth has eluded LAC for more than a century
 - Stark illustration that the productive capacity in LAC lacks the efficiency and flexibility to accommodate robust long-run growth rates
- The region is well positioned to overcome its relax structural speed limits to growth
 - Progress in the stability and equity agendas
 - For many countries, opportunity to capitalize on the commodity price windfall

Thank you